Editor's note: 89 I.D. 208

NOLA GRACE PTASYNSKI

IBLA 79-522 Decided April 19, 1982

Appeal from the decision of the Acting Director, Geological Survey, denying an appeal from the decision of the Area Oil and Gas Supervisor, Casper, Wyoming, requiring payment of compensatory royalty on oil and gas lease W-39532.

Affirmed as modified.

1. Oil and Gas Leases: Compensatory Royalty--Oil and Gas Leases: Drainage--Oil and Gas Leases: Drilling

   Neither the standard lease terms nor the applicable regulation, 30 CFR 221.21(c), require the payment of compensatory royalty for drainage from Government lands, where it can be established that a prudent operator would not drill an offsetting well.

2. Rules of Practice: Appeals: Failure to Appeal--Rules of Practice: Appeals: Timely Filing

   Where the Geological Survey informs an oil and gas lessee that completion of a well on an adjacent tract of land has resulted in substantial drainage from the Government's land and directs the lessee to either complete an offset well or

tender compensatory royalties, the lessee may attempt to show that the drainage is not substantial or that a prudent operator would not attempt to complete a paying well. Where, however, the lessee does not challenge the factual predicates of the Survey demand within a reasonable time after he has been informed of them, the right to subsequently contravene the factual determinations of Survey on these points is waived.

3. Oil and Gas Leases: Compensatory Royalty--Oil and Gas Leases: Drainage

Where a lessee, after due notice, fails to submit evidence that a requested offset well was unneeded, and also fails to timely complete the well, compensatory royalty is properly assessed, regardless whether the well which is eventually drilled is "a paying well."

4. Oil and Gas Leases: Compensatory Royalty--Oil and Gas Leases: Drainage

Before a lessee may plead impossibility of performance as a bar to fulfillment of a contractual requirement, the lessee must show that no alternate method of compliance is possible. Where possible alternatives exist, a lessee is not excused from a contractual obligation merely because one alternative is not feasible.

5. Oil and Gas Leases: Compensatory Royalty--Oil and Gas Leases: Drainage

Compensatory royalties for failure to complete a protective well are properly assessed after a reasonable time from notice of drainage by the lessor until an offset well has been completed.

APPEARANCES: W. F. Drew, Esq., Casper, Wyoming, for appellant.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

Nola Grace Ptasynski has appealed the decision of the Acting Director of the Geological Survey (Survey), dated June 18, 1979, denying her appeal of the decision of Survey's Casper, Wyoming, Area Oil and Gas Supervisor requiring payment of compensatory royalty on oil and gas lease W-39532. Only the part of this lease which embraces the NW 1/4 NE 1/4 of sec. 33, T. 36 N., R. 69 W., sixth principal meridian, Converse County, Wyoming, is the subject of the dispute in this case.

By certified letters, dated September 24, 1976, and April 26, 1977, Survey notified appellant and the lessees of oil and gas lease W-35689 that completion of a well, designated as No. 2-33 on the NE 1/4 NW 1/4 of sec. 33, T. 36 N., R. 69 W., sixth principal meridian, on April 13, 1976, would result in drainage of the lands covered by their leases and therefore required communitization of the area and drilling of a protective well or, alternatively, payment of compensatory royalties. 1/ Noting that, under the standard terms of the leases, appellant and the other lessees had agreed to drill any wells necessary to protect the leased lands from drainage or to compensate the Federal Government for the estimated loss of royalty through drainage, Survey informed appellant that, in the absence of diligent drilling operations, compensatory royalties would be assessed as of April 13, 1976. Both letters, gave appellant the opportunity to contravene Survey's determination that

1/ While both letters referred only to drainage being caused by well No. 2-33 in the NE 1/4 NW 1/4 sec. 33, subsequent assessments of compensatory royalty indicated that drainage was also being caused by well No. 1-33 in the NE 1/4 SW 1/4 sec. 30.

drainage was occurring. Thus, the April 26, 1977, letter stated "if you contend that no offset protection is necessary, detailed engineering, geologic, and economic data should be furnished to justify this position." When appellant did not submit any justification or evidence of drilling on her leased lands, Survey issued a decision letter, dated September 28, 1977, assessing, compensatory royalty on appellant's lease.

Appellant responded by letter dated October 25, 1977, asserting that the demand for compensatory royalty was inappropriate and requesting that the decision be changed. She claimed that, under the established drilling and spacing units for sec. 33, it was impossible for her to drill on her 40 acres independently, 2/ and that the other lessees in the NE 1/4 had earlier declined to drill because they believed that any well would be of doubtful commercial value. She indicated that, nevertheless, they had proceeded jointly to drill a well on the NE 1/4 NE 1/4 of sec. 33 and would attempt completion. Appellant argued that she has diligently developed the other portions of her lease, and suggested that it was inequitable to assess her compensatory royalties under the totality of the relevant circumstances.

2/ By order dated Dec. 2, 1975, the Wyoming Oil and Gas Conservation Commission had established 160-acre drilling and spacing units for the production of oil and associated gas from the Teapot formation in the Well Draw Field, Converse County, Wyoming. The order covered all of sec. 33, T. 36 N., R. 69 W., sixth principal meridian, and provided that the permitted location for a test well in the NE 1/4 would be the center of the NE 1/4 NE 1/4. The Commission later entered a permanent order establishing the 160-acre units for sec. 33 and the same permitted drilling location. Appellant, as lessee of the NW 1/4 NE 1/4 of sec. 33, was therefore prohibited from drilling on her own leasehold and held no interest in the leases covering the NE 1/4 NE 1/4 of sec. 33. In February 1977 appellant executed an authorization for expenditure whereby she agreed to pay her 25 percent share of the cost of drilling and completing the well in the NE 1/4 NE 1/4 of sec. 33, but the lessees of the E 1/2 NE 1/4 of sec. 33 declined to drill the well at that time because of the questionable commercial value of such well.

By letter dated February 3, 1978, Survey notified appellant that the compensatory royalty assessment for drainage from the offset wells would terminate as of November 14, 1977, the completion date of the protective well located on the NE 1/4 NE 1/4 of sec. 33. 3/ The letter reiterated that the royalty payments were then due and payable without addressing the contentions in appellant's October 1977 letter. In response, appellant reiterated the arguments in the October letter and again requested that the decision assessing compensatory royalty be reversed. On February 28, 1978, Survey again notified appellant that the royalty payments were due and stated that "the assessment to protect your Federal lease W-39532 from drainage * * * will not be waived. This assessment is not a penalty but protection against drainage by offset wells to Federal leases." The letter also stated that appellant had the right to appeal the decision to the Director of Survey.

Appellant filed a notice of appeal with the Director and statement of reasons on March 29, 1978, 4/ which summarized her arguments as follows:

> WHEREFORE, for the reason that this Appellant was prohibited by orders of the Wyoming Oil and Gas Conservation Commission from drilling a test well to the Teapot formation in the NW 1/4 NE 1/4 of Section 33, Township 36 North, Range 69 West; because this Appellant could not drill on a lease owned by another party at the approved location in the NE 1/4 NE 1/4 of said Section 33; and, for the reason this Appellant did in 1976, agree to pay her

3/ The Feb. 3 letter noted that until a communitization plan was approved by Survey, appellant would be assessed, for royalty purposes, 25 percent of the production of the well. A communitization plan was eventually approved on Mar. 22, 1978, with an effective date of Oct. 1, 1977.

4/ By letter dated Apr. 24, 1978, appellant also requested that payment of the compensatory royalties be held in abeyance pending the decision on appeal. On June 30, 1978, the Acting Director of Survey denied this request and indicated that the contested royalty payments would be refunded or credited to the proper account should the decision on appeal be favorable to appellant.

> proportionate 25% of the cost of drilling a test well to the Teapot formation in the NE 1/4 NE 1/4 of said Section 33, and said well was not at that time drilled because the owners of the oil and gas leasehold estate in the E 1/2 NE 1/4 of said Section 33 declined to participate in a well at a location in accordance with the orders of the Wyoming Oil and Gas Conservation Commission, it is inequitable and unjust to assess this Appellant compensatory royalty.

The Acting Director of Survey denied this appeal by a decision dated June 18, 1979, which stated:

> The order appealed from is presumptively valid. Gables by the Sea v. Lea, 365 F. Supp. 826 (S. D. Fla., 1973), aff'd 498 F.2d 1340 (C.A. 5, 1974), Cert. den., 419 U.S. 1105. Thus, appellant had the burden of showing its invalidity.
>
> Appellant did not establish that offset protection was unnecessary since she failed to show that there was no drainage from her lease, and the record indicates that the offset well will be a paying well.
>
> Appellant alleges that (1) the spacing orders of the Wyoming Oil and Gas Commission prohibited drilling of an offset well on her lease; and (2) the offset well was not drilled earlier because participation by the owners of adjacent private lands was required by the State Oil and Gas Commission, and such adjoining property owners initially declined to participate in the drilling of the well. However, none of these alleged events relieve appellant of her obligation to make compensatory royalty payments. Under the regulations (30 CFR 221.21(c)), where there is drainage a lessee is obligated to pay compensatory royalties in the absence of a protective well irrespective of whether the lessee is in fact able to drill a protective well.

From this decision, appellant has taken this appeal. In her statement of reasons, appellant focuses on the emphasized portion of the following paragraph of Survey's September 28, 1977, decision letter:

> Our District Engineer, Mr. James Shelton, notified you by certified mail on April 26, 1977, that in the absence of commencing a protective well or submitting convincing evidence that a

> paying well could not be drilled on a legal location to protect our lease W-39532 from drainage by well No. 2-33 in the NE 1/4 NW 1/4 section 33 and well No. 1-33 in the NE 1/4 SW 1/4 section 33, both in T. 36 N., R. 69 W., Well Draw field, Converse County, Wyoming, that compensatory royalty would be assessed for the estimated value of the drainage. [Emphasis added.]

Reiterating arguments made to the Director of Survey, appellant contends that the only "legal location" on which a protective well could have been drilled was in the NE 1/4 NE 1/4 of sec. 33, the lease for which was held by other parties. She argues that it was not through lack of her own diligence that she could not drill the necessary protective well. She further indicates that Survey "has interpreted the regulations as not requiring the payment of compensatory royalty or the drilling of an offset well in a case where the lessee shows that such well would not be a paying well." She argues that the well which eventually was drilled on the NE 1/4 NE 1/4 of sec. 33 was not a "paying well" and, thus, she should not have to pay compensatory royalties.

[1] Before commencing an analysis of appellant's argument we must take note of a legal memorandum from the Associate Solicitor, Energy and Minerals, to the Chief, Conservation Division, Geological Survey, dated April 11, 1979, which related to the instant appeal and appears as part of the case record. In the course of this memorandum, the Associate Solicitor stated that, under the terms of the lease, the prudent operator standard was not applicable and, therefore, it was error for the Supervisor to advise a lessee that "convincing evidence that a paying well could not be drilled on a legal location" would relieve the lessee of the obligation to either drill or pay compensatory royalty. The Associate Solicitor stated further:

> When a Federal lease is being drained, the supervisor has authority to assess compensatory royalty liability under the regulation 30 CFR 221.21(c). That provision requires the lessee to receive approval from the supervisor to pay royalties in lieu of drilling offset wells. However, it does not authorize the supervisor to relieve the lessee of both her obligation to drill and to pay compensatory royalties, unless, of course no drainage is occurring. If drainage occurs the regulations only authorize the supervisor to accept compensatory royalties in lieu of drilling.
>
> Therefore, we conclude that unless and until 30 CFR 221.21(c) is amended to incorporate the prudent operator rule of profitability, waivers of compensatory royalty liability in cases where lessees cannot drill a paying well should be halted.

This argument goes to the heart of appellant's contention, for if, indeed, the obligation to prevent drainage is absolute, failure to drill an offset well cannot be excused regardless whether the failure is occasioned by forces beyond a lessee's control. While we have carefully considered the argument advanced by the Associate Solicitor, we cannot give our agreement to his position.

First, we do not agree that the prudent operator standard is inapplicable to Federal leases. The prudent operator rule is, in essence, a limitation on the generally recognized implied duties of a holder of an oil and gas lease, including the duty to prevent substantial drainage from the leased land and to drill offset wells for this purpose. Thus, courts have long noted that:

> Under the usual statement of the standard for prudent operation there is no obligation upon the lessee to drill offset wells unless there is a sufficient quantity of oil or gas to pay a reasonable profit to the lessee over and above the cost of drilling and operating the well.

Olsen v. Sinclair Oil & Gas Co., 212 F. Supp. 332, 333 (D. Wyo. 1963). See also Gerson v. Anderson-Prichard Production Corp., 149 F.2d 444, 446 (10th Cir. 1945); Vickers v. Vining, 452 P.2d 798, 802 (Okla. 1969).

The conceptual basis of the prudent operator rule lies in the fact that oil and gas leases are business arrangements entered into with an expectation of financial gain on both sides. As such, one could not rationally expect that a lessee would drill an offset well to prevent drainage where there was no likelihood that such a well would be profitable. Accordingly, the law implies no such obligation. 5/

The question presented to this Board, however, is slightly different. The memorandum of the Associate Solicitor did, indeed, recognize that the prudent operator rule generally applied to the implied covenant to prevent drainage. The memorandum argued, however, that the lease terms and the applicable regulations established an express obligation to prevent drainage -- an obligation which was not modified by the prudent operator rule.

This analysis was based primarily on an interpretation of 30 CFR 221.21(c). That regulation provides:

> The lessee shall drill diligently and produce continuously from such wells as are necessary to protect the lessor from loss of

5/ We do recognize that the prudent operator limitation does not necessarily apply where the lessee of the area being drained is also the owner of the well that is draining the leased tract, the so-called "fraudulent drainage" situation. Since this situation is not present in the instant appeal, we will not further explore the rules that apply in this specialized situation. See generally 5 Williams and Meyers, Oil and Gas Law § 824 (1981); Williams v. Humble Oil & Refining Co., 290 F. Supp. 408, 417-19 (D. La. 1968), aff'd, 432 F.2d 165 (5th Cir. 1970).

> royalty by reason of drainage, or, in lieu thereof, with the consent of the supervisor, he must pay a sum estimated to reimburse the lessor for such loss of royalty, the sum to be computed monthly by the supervisor.

Thus, this regulation provides (1) that the lessee shall drill "to protect the lessor from loss of royalty by reason of drainage," or (2) in the alternative, the Supervisor may allow payment of compensatory royalty which will be computed on the basis of the lessor's loss of royalty. 6/

The lease also expressly sets out the same requirement. Section 2 states that the lessee agrees:

> (c) Wells.--(1) To drill and produce all wells necessary to protect the leased land from drainage by wells on lands not the property of the lessor, or lands of the United States leased at a lower royalty rate, or as to which the royalties and rentals are paid into different funds than are those of this lease; or in lieu of any part of such drilling and production, with the consent of the Director of the Geological Survey, to compensate the lessor in full each month for the estimated loss of royalty through drainage in the amount determined by said Director.

Based on these provisions the Associate Solicitor concluded that the obligation to drill offset wells was absolute in nature and that the only way to avoid unproductive drilling was by payment of compensatory royalty. We cannot assent to this interpretation.

While it has been recognized that express terms may modify the implied covenant to prevent drainage, the argument advanced by the Associate Solicitor is unique. The cases dealing with express modifications have almost

6/ The last phrase represents an election on the part of the Government to pursue compensation on the basis of the royalty which would have been paid on the hydrocarbons drained by the offending well as opposed to the royalty which would have resulted had an offset well been drilled when it should have been.

universally grown out of attempts by the lessee to evade the requirement that an offset well be drilled, in situations where the prudent operator standard has been met, by pointing to an express limitation on the duty to protect the leased lands. 7/ In contradistinction, here the Associate Solicitor is positing an express requirement that a lessee drill where a reasonably prudent operator would not. Our analysis of 30 CFR 221.21(c) does not support the Associate Solicitor's conclusion.

In the first place, it can scarcely be argued that the language of the regulation clearly attempts to nullify the prudent operator limitation. As the Associate Solicitor pointed out, the substance of the regulation has been the same since 1942. See 30 CFR 221.21(c) (1949). Yet, since 1942, Survey has apparently allowed proof of economic infeasibility to nullify the requirement that a lessee either drill or pay compensatory royalty. 8/

Secondly, the wording of the regulation, even given the Associate Solicitor's interpretation that the "either/or" dichotomy is incapable of waiver, could easily be interpreted as implicitly embracing the prudent operator standard. The key word here is "drainage." As a general rule, the implied covenant to prevent drainage arises only where the drainage is "substantial." See, e.g., Gerson v. Anderson-Prichard Production Corp., supra at 446. Regardless of whether one views this requirement as merely a restatement of

7/ See, e.g., Williams v. Humble Oil & Refining Co., supra at 413-17; Shell Oil Co. v. Stansbury, 410 S.W.2d 187-88 (Tex. 1967).

8/ We say "apparent" since not only did the Oil and Gas Supervisor afford appellant the opportunity in this case to show that a paying well could not be drilled, but the decision of the Director ignored the Associate Solicitor's memorandum and reiterated the standard.

the requirement that there must be a reasonable prospect of success for the drilling of a paying well, or as an additional standard which must be met before recovery may be had for breach of the protection covenant, 9/ the fact remains that, for the Solicitor's interpretation of 30 CFR 221.21(c) to be correct, the regulation must be construed as not requiring "substantial" drainage, in addition to not requiring a likelihood of a paying well. It would be expected, however, that if so marked a variance from the general rules relating to protective wells were intended it could have been accomplished with greater precision and specificity.

Finally, the Associate Solicitor's conclusion is suspect precisely because it results in the imposition of economic obligations on the lessee which clearly do not involve rational economic considerations. If the recoverable oil underlying the land where drainage is occurring is insufficient to support the cost of recovery, no intelligent landowner would make out-of-pocket expenditures to drill a well. The oil lost through drainage is not an economic loss to the landowner, because its attempted recovery would actually cost the landowner money. Thus, while in some conceptual sense the landowner has lost the oil drained, there has been no economic loss occasioned by the drainage. 10/ The landowner is no worse off than he was before the offending well commenced to drain his meager reserves, and considerably better off then he would be if he tried to recover them by drilling an offset well. A lessee should not be obligated to pursue a course of economic folly which a prudent owner would forego.

9/ See 5 Williams and Meyers § 822.1.
10/ In the legal sense, of course, where the law of capture applies, the landowner has suffered no legal loss whatsoever since the right of ownership of such fugacious substances arises only when they are reduced to the landowner's possession.

It is difficult to understand why the Government would contend that, while no prudent operator would drill in such a situation, it is nevertheless required that the Government's lessee drill or pay compensatory royalty. For one thing, it is hard to quantify proper "compensation" when there is, in point of fact, no real economic loss to the Government through drainage. The Government is not seeking to be made whole, but, on the contrary, is attempting to obtain an actual benefit beyond any economic loss actually suffered. It may be that the United States might desire to enforce such a requirement. But, in the absence of a regulation specifically countenancing this result, thereby giving notice to all prospective lessees, we cannot agree with the Associate Solicitor's analysis. Cf. Pan American Petroleum Corp. v. Udall, 192 F. Supp. 626, 630 (D.D.C. 1961). Accordingly, we expressly hold that where the evidence establishes that a prudent operator would not drill an offset well to protect against drainage there is no requirement that the lessee nevertheless either drill the offset well or tender compensatory royalty.

[2] Having determined that the prudent operator exemption does apply to Federal oil and gas leases, the next question we must examine is whether or not appellant timely interposed an objection to the order that she drill or pay compensatory royalty. As we noted above, both the September 24, 1976, and the April 26, 1977, letters afforded appellant an opportunity to show that "no offset protection is necessary." Appellant made no effort at either time to show that a paying well could not be completed. When appellant finally responded to the September 28, 1977, letter assessing compensatory royalty, she did argue, in passing, that an offset well might not be productive but, even at that time, the thrust of her argument was that she had made a good faith effort to drill a well but had been unable to drill without the

cooperation of the other parties holding the operating rights in the NE 1/4 sec. 33. By this time, over a year had passed since appellant was first afforded an opportunity to respond to Survey's directive. When she failed to contravene, in a timely manner, the determination of Survey that substantial drainage was occurring which necessitated the drilling of an offset well, she waived her right to contest the Survey determination on the ground that substantial drainage was not occurring. Indeed, the fact that appellant and the other parties did subsequently complete a well indicates that the possibility of the existence of substantial drainage was at least sufficient enough to justify the expenditure of $408,575.

[3] The fact that the well which was drilled may not be a paying well does not affect the validity of the compensatory royalty determination. 11/ Appellant was allowed an opportunity to submit evidence that an offset well was not needed. Failing in this, she was required to (1) drill an offset well or (2) pay compensatory royalty. Appellant offered no evidence that an offset well was unneeded. When she failed to drill the well within a reasonable period of time, compensatory royalty was properly assessed.

The Government's right to indemnification by the assessment of compensatory royalty attached a reasonable time after notification and continued until the completion of a protective well. From the point of its initiation, compensatory royalty was a continuous obligation until an offset well had been completed. Even if it could be shown that the completed well was not a

11/ We recognize that the Area Oil and Gas Supervisor has contended that the well is a paying well. See memorandum of May 30, 1978, to Chief, Conservation Division. As the text indicates, however, the question is not dispositive of the issues presently before the Board.

paying well, there could be no refund of compensatory royalty payments as they had already accrued through the failure of the appellant to take specified steps to avoid the assessment.

Indeed, there was a quid pro quo involved herein since the continuation of the lease was, in the absence of a protective well, totally dependent upon compensatory royalty. When the protective well was completed the compensatory liability terminated, but until such completion only the compensatory royalty payment prevented the Government from taking action to cancel the lease. Further, appellant failed to appeal timely the Survey determination that compensable drainage was occurring.

[4] We recognize that the main thrust of appellant's argument goes to the inability of appellant to drill absent the approval of the other leasehold owners in the NE 1/4. Appellant argues that:

> This Appellant did, under date of February 7, 1977, agree to pay her proportionate 25% of the cost and expense of drilling a test well to the Teapot formation at the said legal location in the NE 1/4 of said Section 33 and this well was not drilled at that time because the owners of the oil and gas leasehold in the E 1/2 NE 1/4 of section 33 declined to participate in a well at the legal location. It is therefore inequitable and unjust to assess this Appellant compensatory royalty.

It is, of course, generally accepted that where performance of a contract has been rendered impossible by a judicial or administrative order, a contractual duty thereby prohibited is considered discharged. See, e.g., Restatement (Second) on Contracts § 264. Courts have also recognized that "[a] lessee who fails to drill an offset well in violation of a valid well

spacing regulation does not breach his duty under the prudent operator standard." U.V. Industries, Inc. v. Danielson, 602 P.2d 571, 580 (Mont. 1979). Appellant contends that since it was not possible, consistent with state spacing requirements, for her to drill on her lease, there was no breach of the protection covenant and, thus, she should not be assessed compensatory royalty. We disagree.

In Ashland Oil & Refining Co. v. Cities Service Gas Co., 462 F.2d 204 (1972), the Tenth Circuit Court of Appeals examined the question of the consequence of failure "because of impossibility of one of two alternate performance provisions in a contract." Id. at 211. The court held that the impossibility of one alternative rendered the alternate undertaking operative. This holding was reaffirmed in Cook v. El Paso Natural Gas Co., 560 F.2d 978, 982 (10th Cir. 1977). In the instant case, while appellant might not have been able to drill on her lease, not only did she have the alternative provided of paying compensatory royalty, she had the additional possibility of applying for a spacing exemption. Before appellant can be allowed to plead impossibility of performance, she must show that all reasonable steps were taken, and that performance was, indeed, impossible. Cf. U.V. Industries, Inc. v. Danielson, supra. Appellant, having never applied for a spacing exception, will not be permitted to complain that she had no possible method of complying with the requirement that she drill to prevent drainage. See Kirkpatrick Oil and Gas Co., 15 IBLA 216, 229-30, 81 I.D. 162, 168-69 (1974). 12/

12/ Since appellant failed to object timely to Survey's determination that substantial drainage was occurring and its implicit holding that a paying well could be drilled, consideration of appellant's argument as to impossibility must be premised on a view that a paying well was possible.

[5] We turn now to the last question which this appeal poses. In the letter of September 28, 1977, the Oil and Gas Supervisor assessed compensatory royalty at the rate of 8 percent of the value of production from well No. 2-33 times the 12-1/2 percent royalty rate, effective April 13, 1976, and also levied an assessment of 2 percent of the value of production of offending well No. 1-33 times the 12-1/2 percent royalty rate effective October 17, 1975. As appellant has not challenged the percentage assessed, we will let it stand. What concerns us, however, is the assessing of royalty from April 13, 1976, and October 17, 1975, respectively.

The two dates used for computation of the compensatory royalty are the completion dates of the respective offending wells. Survey has contended throughout this appeal that compensatory royalties are assessed to recover royalties lost due to drainage and not as a form of penalty. However, as we shall show, utilization of the completion dates of the offending wells, as the starting point for assessment of compensatory royalty, imposes precisely the type of penalty for noncompletion of a protective well that Survey insists it does not intend.

The obligation to protect a leasehold from drainage arises not upon completion of the draining well, but only after the passage of a reasonable time subsequent to notification by the lessor that an adjoining well is draining the leasehold. 13/ See U.V. Industries, Inc. v. Danielson, supra at 585. Thus, had appellant herein proceeded to complete an offset well within a reasonable time after notice, there would have been no assessment for intervening

13/ We recognize that, where the lessee is responsible for the draining well, the requirement of notice may be dispensed with.

drainage. If compensatory royalty is designed to compensate the lessor for drainage occurring because of a failure to complete a protective well, it is difficult to understand why the lessor should be compensated for the period of time during which the lessee was under no obligation to drill, viz., from completion of the offending well to a reasonable time after notification. The only way we could justify such an assessment was if, indeed, the Government was penalizing the lessee for failure to drill an offset well. The compensatory royalty of the initial period of time would therefore be a form of damages applicable only where an offset well was not drilled.

We need not decide whether the Department could, or should, provide for such damages. We think it clear that the Department has not yet so acted. Nothing in either the lease terms or the applicable regulation, 30 CFR 221.21(c), can remotely be said to evidence a determination to penalize those who tender compensatory royalties. The regulation itself was expressly interpreted in Pan American Petroleum Corp. v. Udall, supra, as barring liquidated damages.

In the Pan American case, Pan American held leases to adjacent parcels of land, the first of which was allotted to one Woodrow Star, and the second allotted to one Ella Many Ribs, both Indians of the Fort Berthold Indian Reservation in North Dakota. In 1953, a producing well was completed on the land within the Star allotment. In 1955, the Department assessed compensatory royalty against Pan American on behalf of Ella Many Ribs based on 100 percent of the production of the Star well. This assessment was subsequently decreased to 50 percent of the production from the Star well, together with 50 percent of the production from another producing well, which was also on

land adjacent to the Ella Many Ribs allotment. The compensatory royalty was tendered under protest as to the manner of its computation. In 1957, a well was completed on the Ella Many Ribs tract, thereby terminating compensatory royalty liability. Pan American eventually brought the dispute over the rate of assessment to Federal court.

Before the district court, the Department argued that under the terms of the lease and regulations, the Secretary could have absolutely required the drilling of the offset well, and, therefore, he had equal authority to assess 100 percent compensatory royalty in lieu of drilling a well as a form of liquidated damages. While the court admitted that the Secretary did have the "absolute" right to require the drilling of an offset well, 14/ it held that once he elected to permit the payment of compensatory royalty he was required to assess it so as to actually compensate for the loss. And, as Assistant Secretary Anderson subsequently noted, "compensatory royalties are, in essence, payments made to 'compensate' the lessor for production royalties estimated to be lost as a result of a failure to drill offset wells." Pan American Corp., IA-1578 (Feb. 29, 1968) (emphasis supplied). Royalties lost because of a failure to drill an offset well do not commence on the completion of the offending well but rather upon the failure to offset that well in a reasonable time after notice.

While the Secretary might, for good and sufficient reasons of policy, determine to relate the assessment of compensatory royalty back to the

14/ The word "absolutely" in this quotation should not be read as contrary to our earlier analysis. In Pan American there was no question that substantial drainage was occurring. Id. at 628. The court's use of the term should be read as an analysis of the "absolute" right of the Secretary, under 30 CFR 221.21(c), to require the drilling of an offset well rather than accepting compensatory royalty, where substantial drainage is occurring.

completion of a draining well as an incentive to the drilling of offsetting wells, it is impossible to read the present regulation as encompassing this intent. Therefore, we find that Survey's decision assessing royalty from the date of the completion of the offending wells is unjustified and we hereby modify the decision below to authorize the imposition of compensatory royalty for the period from April 26, 1977, to November 14, 1977.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed as to the assessment of compensatory royalty, as modified herein.

James L. Burski
Administrative Judge

We concur:

Bernard V. Parrette
Chief Administrative Judge

Edward W. Stuebing
Administrative Judge